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Economics Group

Special Commentary

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Employment: Growth Is Finally Coming

A Government-Induced Turn, but a Turn Nonetheless

After nearly two straight years of job losses, the month of November finally caved, giving a long-awaited positive payroll reading. Declines returned in December, however, and although we will likely see another loss in January, by early spring we may see the beginning of a string of employment gains. Yet several countervailing currents—decennial, cyclical and secular—will all be in play. The most temporary and perhaps largest swing factor will be the decennial 2010 Census-related hiring and subsequent layoffs. Second, as the economy recovers there will be a natural cyclical improvement in the labor market and hiring should start picking back up across several private sectors. Finally, the most lasting of influences will be the ever ongoing secular changes in the economy that drive the supply and demand for labor over the long-run.[1]

Figure 1

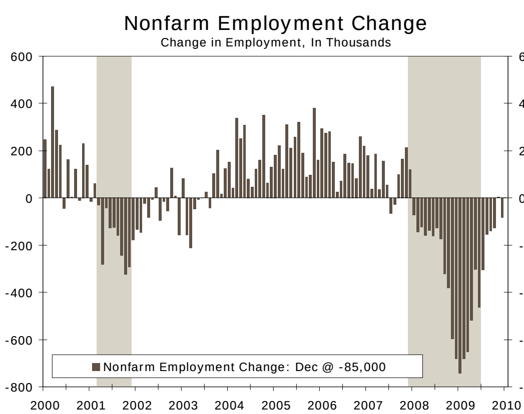
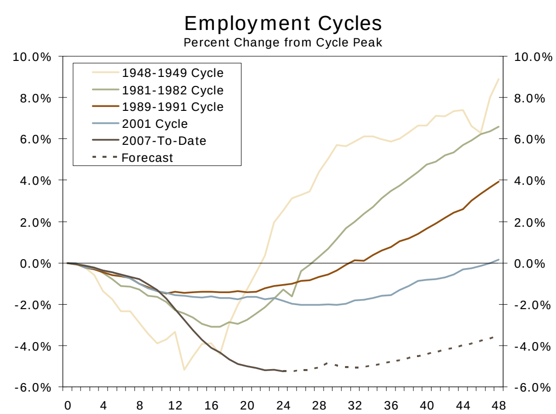


Figure 2



Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

Each of these elements will affect, both positively and negatively, payroll growth in the near term. Census hiring will be a large positive from February through May before reversing its impact from June through September. At the same time, private payrolls will likely be gaining cyclical momentum, but should still be negative for the first quarter. Finally, secular concerns will continue to shift jobs on net from industries such as old-line manufacturing to healthcare and other service industries. Considering the above influences, job losses are likely to abate early this year, but this will not represent the end of the problems for the labor market and consumers. Unemployment will remain higher longer this cycle as production changes and labor force participation will influence the labor market. At the same time, wage growth will likely be tepid at best until 2011.

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[1] **See our previous discussion on the subject, "Employment – Have We Reached a Turning Point?" published on June 1, 2009.**

Census Hiring Cycle to Kick-Start Positive Payroll Numbers

The Census Bureau must staff up with a considerable temporary workforce to conduct the decennial census every 10 years. This year, the Census Bureau plans to fill a total of 1.2 million temporary positions across the country. Not all of these hires will be on the payroll at one time, so the impact should be spread out over several months and will not be as large as the total hires figure suggests in the establishment data. For reference, this is about 235,000 more than were hired in 2000, which was not an unusual increase. If past censuses provide an appropriate guide, we expect payroll employment will start to see a considerable boost by February of this year. While many of the census jobs will be short-lived (most last for a mere 6-8 weeks), government payrolls should continue to rise for several months with the maximum effect coming in May. After this, we should see a rapid unwind in employment with considerable declines in government employment in June tapering off through September. By the fourth quarter the effects of the census should be behind us and the gains we are expecting in payrolls will be almost entirely from the private sector.

Figure 3

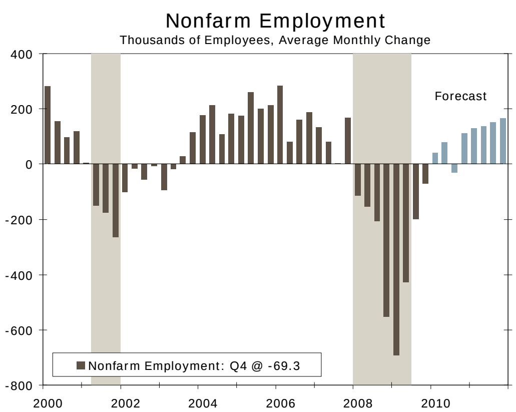
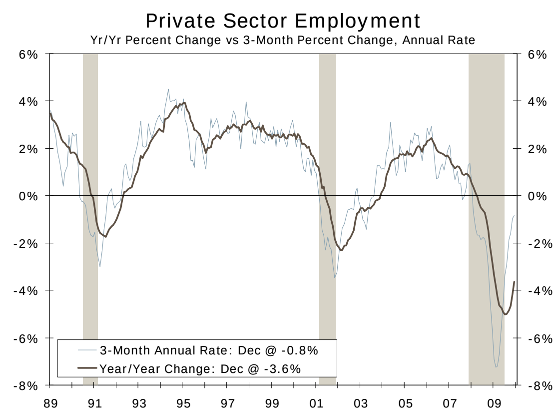


Figure 4



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Private Sector Will Begin to Help as Government Support Wanes

As the government staffs up for the census and then sheds those employees, the private sector labor market should see gradual improvement. Private employers will likely start adding jobs slowly by the second quarter. By the fourth quarter, we expect private payrolls to be growing at a pace of roughly 100,000 jobs per month. As we move into 2011, employment gains should continue to pick up momentum along with the rest of the economy. By late next year, private employers could be adding nearly 150,000 jobs per month.

The recovery in private employment will likely be uneven across industries; some of the hardest hit sectors such as manufacturing and construction will continue to struggle, but for very different reasons. In construction, we expect the cyclical concerns to continue to hold back employment in a sector that has lost almost a quarter of its labor force. We expect some limited recovery in residential construction this year, but commercial construction is likely to continue to decline. This will limit net job growth in the sector for the near term. However, construction will eventually join the cyclical recovery unlike sectors such as manufacturing. In manufacturing, we continue to see a long-run secular decline in employment. Production has been ramping up, but there is not really a need to add employees in a meaningful way yet. Manufacturers are more likely to ramp up the hours of current employees and look for process efficiencies to increase output before they resort to hiring more workers. Also, many of the manufacturing jobs that were lost in this cycle will not be coming back. Those jobs were at small, labor-intensive plants that were unable to weather the downturn and have permanently closed. On the other hand, sectors such as healthcare continue to benefit from long-run changes. An aging populace will likely demand more and more healthcare over the coming decades, and the sector will need additional employees to handle the coming tide of customers.

The employment diffusion index tells us a lot about the breadth and, consequently, the sustainability of labor market improvements. The diffusion index remains troublingly low, but the improvement over the second half of 2009 was considerable.[2] At the depth of the recession in late 2008, nearly 80 percent of industries were cutting jobs, whereas today roughly 40 percent of industries are adding jobs on net (Figure 6). In the wake of the 2001 recession, the diffusion index slid into the high 30s and failed to gain traction. In fact, during the "jobless recovery," the diffusion index did not break 50 until late 2003. Payroll gains are certainly not predicated on the diffusion index breaking 50; however, we would be encouraged by further gains in the diffusion index over the next few months. A broad swath of private employers will need to be adding jobs by summer if they are to have any hope of offsetting the major government payroll declines. Without improvement in the diffusion index, we would be concerned that private payroll growth might not be able to maintain positive payroll numbers in the second half of the year.

Figure 5

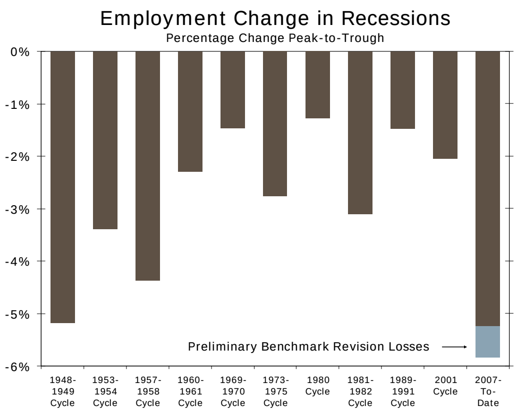
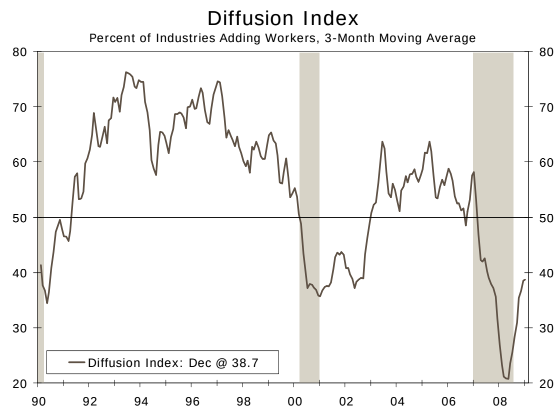


Figure 6



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Benchmark Revisions Complicate Data, but not Overly Significant

Of further importance, the next release of the employment situation (February 5th) in addition to preliminary January data will also include the annual revision to the establishment data. The Bureau of Labor Statistics (BLS) has already announced a preliminary estimate for the revisions, which showed a net loss of more than 830,000 jobs compared to previous estimates. While these revisions are not reflected in our data series or charts, they make it quite clear that the job cycle that has just ended will have witnessed the biggest decline in jobs in the post-war period. Total job losses will approach six percent of total employment surpassing even the 1948-49 cycle. The only silver lining is that these data represent jobs that were lost many months ago and were simply not captured in official data. Regardless of the size of the revision that is finally reported, we believe the labor market is on its way to a slow but meaningful recovery.

Unemployment and Hours Worked: One Laggard, One Leader

Our expectation is for cyclical improvement in the labor market, despite the unusual variations in the data caused by benchmark revisions and the decennial census. This improvement will not be particularly evident in the unemployment statistics, however, where we expect increases through the end of 2010 before a slow retreat in 2011. The sub-five unemployment rate of yesteryear is even further out on the forecast horizon, and any eventual return to that level is subject to innumerable risks, including legislative risk. Coming back to the near term, the unemployment rate has been held down in recent months by a sharp drop in labor force participation (Figure 7).

[2] **A reading above 50 would indicate that more industries are adding employees on net than are cutting them.**

Nearly two million people have chosen to leave the labor force for one reason or another over the past eight months. This has led to the lowest rate of labor force participation since the mid-1980s when female participation was still in a long-term secular up trend, making cyclical comparisons difficult. Some of these workers will remain on the sidelines only until they believe that they can find a new job immediately. As the employment picture brightens in the coming months, we would expect some labor force reentrants to emerge. As workers reenter the labor force to look for work, they will again be counted as unemployed and will push the unemployment rate higher. This should be at least partially offset by renewed hiring, but the hiring will not likely be at a fast enough pace to push down the unemployment rate until late 2010 or early 2011. Massive census hiring may induce workers to seek employment. Once the short-term stint with the Census Bureau ends, it remains to be seen whether they remain in the labor force or slide into nonparticipation. The portion of the unemployment rate made up of those who have lost their jobs likely peaked in October 2009 at 6.7 percent and improved in the two subsequent months (Figure 8). At the same time, however, reentrants are holding their portion of the unemployment rate steady, contributing 2.2 percentage points. We would expect this to both rise and contribute a growing portion of the total unemployment rate over the next year. Like the last recession, we eventually should see a recovery and then a leveling off of the labor force participation rate. We may not regain the highs of the late 1990s in the near future as some employees will never seek to reenter the labor force. Some of these may be baby boomers who were nearing retirement age anyway and have chosen to enter retirement early. Others may be permanently discouraged and may simply not attempt to find a job again.

Figure 7

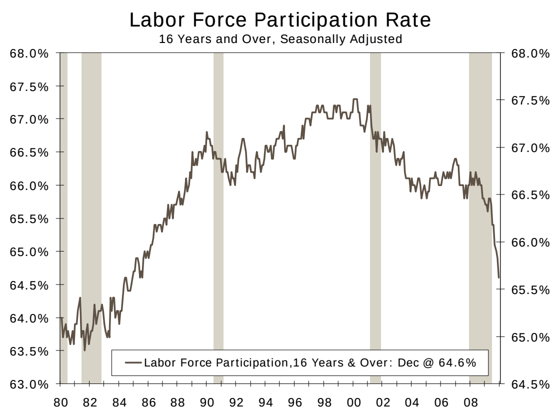
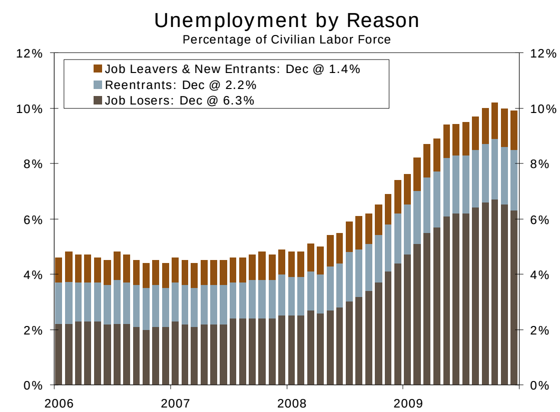


Figure 8



Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Hours Worked: Testing the Waters

Despite minimal hope for rapid improvement in measures of unemployment, another measure of employment conditions, hours worked, is likely to provide a more positive view of the current pulse of the labor market. Even before notable private employment gains, this measure is likely to gradually build strength. Hours worked fell swiftly over the course of the recession as employers took steps to reduce paid hours to cut costs and adjust to falling demand. Hour reduction alone was not enough, however, as evidenced by the millions of jobs that were cut. Now that the vast majority of employment losses are behind us, hours worked will likely begin to notch gains in 2010. Before going into outright hiring mode, firms will likely test the waters with a lower-risk decision, increasing the hours worked for current employees. As recovery settles in, temporary or part-time hiring will be the likely next step for many firms. Part-time hires will raise total hours worked, and as firms become more confident in the sustainability of recovery, an increasing number of industries will return to hiring full-time workers. The resulting increase in the index of hours worked will be another sign that the economy is strengthening, even before large private sector gains. The willingness of firms to test the waters by increasing hours for existing employees will be an encouraging sign, though clearly it is outright employment gains that are most eagerly awaited.

Figure 9

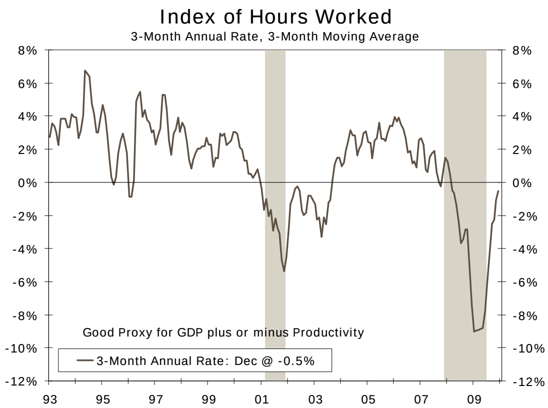
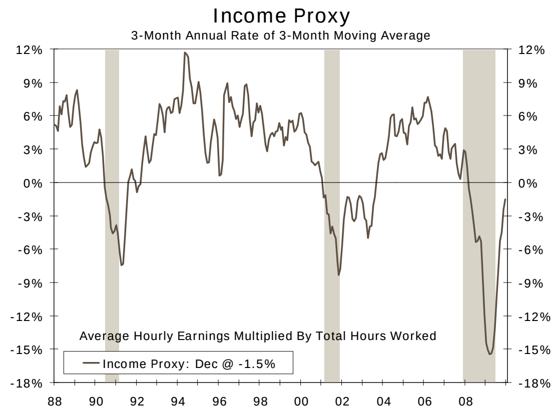


Figure 10



Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Securities, LLC

What Is There to Look Forward to?

Increased hours will benefit employees as income increases along with hours worked, and income will expand further when outright job growth sets in (Figure 10). Compensation gains have myriad positive implications for the individuals and thereby the economy, increasing purchasing power and consumer spending, which supports many consumer-focused businesses. As more businesses begin to see demand and sales pick up, they in turn can hire the next round of workers, spreading new relative prosperity. The stirrings of recovery must start small but will become amplified rapidly as each person and business passes on their increased (even if every so slightly) wealth. Outright employment gains will of course magnify income gains, which can then course through the economy, breathing life into the recovery. This type of organic recovery is vastly preferable to one based primarily on government assistance, as it is self-sustaining and self-reinforcing. While some of the measures of labor market health may be clouded over the first half of the year, we believe we are on the cusp of sustainable job gains.

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